

CONFIDENTIAL

**POTENTIAL IMPACT OF POLISH SITUATION ON
INTERNATIONAL BANKING SYSTEM**

December 16, 1981

CONFIDENTIAL

CONFIDENTIAL

Summary and Conclusion

A default or even a less serious unilateral moratorium by Poland on its debt to commercial banks would constitute a profound shock and perhaps produce some difficulties for a few European banks. It would not create chaos in the international banking system because numerous cushions are built into the system. U.S. and U.K. banks would be hit fairly lightly; selected German and Austrian banks (and a few Latin American banks) are more vulnerable. The broader question of the impact of a Polish collapse on future lending to non-industrial countries is considerably more difficult to assess. Lending to Eastern European countries would be particularly affected if the USSR failed to bail out Poland. Lending to non-oil LDCs probably would not be significantly affected by a Polish default in itself, although banks could be expected to hold out for higher spreads and to avoid the poorer risks.

Debt repudiation by all of Eastern Europe ^{1/} would create a problem three or four times larger in terms of total exposure but an even greater problem in terms of shock to the system. It is less clear that more widespread difficulties could be avoided without the extraordinary intervention of the governments or central banks of the major industrial countries.

The Facts

The extent of the direct impact on private banks of Polish debt repudiation would depend on how much of the debt is guaranteed by official Western entities. Such data are not available on a comprehensive basis except for U.S. banks. As a rough estimate, perhaps one-third of claims of non-U.S. banks is guaranteed, giving the following exposure vis-a-vis Poland as of end June 1981.

\$ billions

	All BIS Banks	U.S. Banks*	Other BIS Banks
Total Bank Claims	14.1	2.1	12.0
less Net Guaranteed (est.)	4.8	0.8	4.0
Total	9.3	1.3	8.0
Memoranda:			
Bank Liabilities	0.5	0.1	0.4
Unguaranteed Claims less Liabilities	8.8	1.2	7.6

* U.S. banks' liabilities derived from Treasury and Federal Reserve Branch data; credit commitments not included.

^{1/} In this paper, Eastern Europe is defined to exclude Yugoslavia.

CONFIDENTIAL

CONFIDENTIAL

2

There are 460 banks involved in the negotiations with Poland. Some 75 to 100 are from countries outside the BIS area. Among the latter, several large Latin American banks are said to have large exposures. (These are additional to the estimated \$8 billion cited above.)

U.S. banks' exposure in Poland, excluding commitments 1/, was \$1,270 million in mid-1981, according to the Country Exposure Lending Survey, down slightly from \$1,461 million at the end of 1980. The ten U.S. banks with the largest dollar amount of exposure accounted for \$900 million, ranging from two percent to six percent of their total capital 2/ with an average of 4 1/2 percent.

The exposure in Poland of non-U.S. banks is probably around six to seven percent of their aggregate capital but may be two or three times as large for a few individual banks. Also, some banks in Germany have experienced a substantial reduction in earnings over the past year and are thus particularly vulnerable to any losses from Polish loans. The British report exposure of their banks to be around four percent of capital.

Regulatory Treatment

A principal issue in the event of a Polish collapse will be the manner in which banks' exposure is treated in their balance sheets and income statements. There is some flexibility in the U.S. in the manner in which nonperforming claims are treated in the balance sheet, but less flexibility regarding the treatment of accrued interest in the income statement. In the event a country fails to service promptly the principal and/or interest on its obligations to U.S. banks, there need be no immediate writeoffs or increases in loan loss reserves. If the situation persists, bank examiners have discretion as to when and at what magnitudes they will require banks to start charging their balance sheets, although banks will normally have taken this step on their own. In previous similar cases (e.g., Sudan, Zaire), chargeoffs did not begin until sometime after the loans became non-performing, and even then chargeoffs were a small fraction of total exposure. The treatment of interest income, however, is less flexible. Interest that is in arrears by more than 60 days must generally be reversed out of income (and subsequent interest payments recorded on a current rather than accrued basis).

1/ of about \$100 million. In the event of a default, commitments would presumably not be honored.

2/ Equity capital, subordinated debentures and loan loss reserves.

CONFIDENTIAL

CONFIDENTIAL

3

Moreover, arrearages on Polish debt have now existed for several months, and failure to reach agreement on a restructuring of debt service would perhaps result in provisions being made promptly. U.S. banks may establish provisions before any encouragement to do so from regulators because of their internal procedures, e.g., related to determining taxable income or in response to outside auditors.

Banks in Europe and Japan, however, could be expected to try to delay in writing down Polish exposure. So long as Poland was engaged in discussion of plans for servicing its debt, pressures in these countries to make provisions for Polish exposure in bank statements would be slight. On the other hand, if the Soviets were to invade Poland and either they or the Western governments refused to begin to deal with the matter of Poland's outstanding indebtedness, or if the Polish government ceased to function for other reasons, the pressures for some provision in bank statements for the outstanding indebtedness would mount rapidly. 1/

Interbank and Foreign Exchange Markets

Although a Polish crisis might have some temporarily unsettling effects for psychological reasons, there should be no longer-run technical factors that could upset the foreign exchange markets. To the extent that foreign banks find themselves short dollars because of interruptions in Poland's service of its dollar debt, the demand for dollars in the foreign exchange markets could increase somewhat, but most banks would have already anticipated non-receipt of scheduled payments. The tendency in the interbank market in the event of major disturbances is for individual banks to reassess the credit limits they maintain for other banks. If it appears that an individual bank might be especially impacted by Polish non-payment, that bank is likely to find it more difficult to borrow in the interbank market without paying some premium, thus further reducing its profitability. These effects, however, are not likely to be significant in a systemic sense -- if a crisis were limited to Poland -- because of the cushions in the system.

1/ A press report on December 14 indicated that the Deutsche Bank had created a contingency fund against bad loans to Poland -- to the surprise of the banking community. Other press reports indicated that a number of German banks may be lodging provisions against up to 20% of their loans to Poland.

CONFIDENTIAL

CONFIDENTIAL

4

Cushions

While U.S. banks as a group are not heavily exposed in Poland, a Polish default would require the principal lenders to absorb a fairly significant reduction in annual post-tax income -- as large as 15 to 20 percent. No U.S. bank would be likely to report negative income for the year solely because of provisions lodged against Polish debt. For many non-U.S. banks, there are large hidden reserves that could be used to reduce the impact of losses on Polish debt, and a significant overall loss on the income statement would be rare (except as indicated above for those German banks with already depressed earnings). It should also be noted that a number of non-U.S. banks are (or are about to become) government owned, including all major French and Italian banks as well as the German Landesbanks. In addition, the Japanese have a long record of support of and close cooperation with their commercial banks.

Central banks of major countries stand ready to assist their banks in the event of shocks that threaten confidence and impair functioning of the banking systems. In the international area, central banks have agreed on a division of responsibility with respect to supervision of the foreign affiliates, which now account for the bulk of international lending, and market practices imply that parent banks stand ready to back the obligations of their affiliates.

Impact of Bloc-wide Repudiation on Future Lending and on Overall Economic Relationships

The magnitudes involved in a bloc-wide repudiation of debt would make it difficult to eliminate the prospect of a significant loss of confidence even with adroit handling by central banks and careful packaging of these and other measures that governments might take. Using rough estimates for guarantees, the position of banks in the 14 countries reporting to the BIS vis-a-vis the Eastern bloc would be as follows at end June 1981.

(\$ billions)

	All BIS Banks	U.S. Banks*	Other BIS Banks
Total Bank Claims	57	5.4	52
less Net Guaranteed (est.)	14	0.6	14
<u>Total</u>	<u>43</u>	<u>4.8</u>	<u>38</u>
Memoranda:			
Bank Liabilities	9	0.8	8
Unguaranteed Claims Less Liabilities	34	4.0	30

* U.S. banks' claims and liabilities from Treasury and Federal Reserve branch data; credit commitments not included.

CONFIDENTIAL

CONFIDENTIAL

5

This exposure is probably spread among around 500 banks, principally in the G-10 countries. The bulk of the exposure in absolute terms will be with the very largest banks. About 80 percent of the unguaranteed claims of U.S. banks are with the 24 largest U.S. banks, and it would not be unrealistic to assume that two-thirds of the unguaranteed claims of non-U.S. banks are with the 34 largest foreign banks. (Nearly all of the Eastern bloc's deposits would be with this group of 58 banks.) The uncovered exposure in Eastern Europe (based on Country Exposure Lending Surveys) of the largest U.S. banks amounted to approximately 11 percent of their combined capital and less than 1/2 percent of their combined assets as of the end of 1980. (These ratios appear to have declined in the first half of 1981.) By comparison, the Eastern bloc exposure of the largest foreign banks would represent about 25 percent of their aggregate capital and less than one percent of their total assets.

Variations from bank to bank in the degree of exposure to the Eastern bloc would result in some non-U.S. banks suffering losses of a substantial portion of their recorded capital in the event of repudiation. Although U.S. banks would be able to survive the direct impact, they would suffer indirectly from any substantial difficulties of other banks. Repudiation would be likely to precipitate a change in the attitudes and lending policies of the banks vis-a-vis other high risk areas of the world, and it might even lead other countries to declare unilateral moratoria on their own debt.

Repudiation of bloc debt would probably have another major global implication. Such an act would virtually guarantee complete Eastern bloc isolation from the Western economies. Not only would the bloc's deposits in banks be frozen, but in view of the inadequate coverage of bloc debt, all other bloc assets (goods, ships, etc.) anywhere in the free world would be subject to attachment. Trade would come to a halt. Moreover, it would be difficult to restore trade even if a solution to the debt problem was subsequently achieved, and, as was the case with Iran, extraordinary measures would be required to restore East-West commerce. This could prove the most important -- perhaps a sufficient -- deterrent to debt repudiation.

In conclusion, the size and distribution of the East European exposure of large banks is of significant scope and importance. In the unlikely event of a bloc-wide default, direct financial assistance to some foreign banks would almost certainly be necessary.

December 1, 1981
updated December 16, 1981

CONFIDENTIAL

EXPOSURE 1/ OF U.S. BANKS vs. EASTERN EUROPE

\$ millions

	<u>Bulgaria</u>	<u>Czech.</u>	<u>GDR</u>	<u>Hungary</u>	<u>Poland</u>	<u>Romania</u>	<u>USSR</u>	<u>Total</u>
--	-----------------	---------------	------------	----------------	---------------	----------------	-------------	--------------

CHANGE

1980

claims	-132	-55	-34	-121	49	-33	-216	-542
commitments	-15	-6	-38	118	-116	3	10	-44
total	-146	-61	-73	-3	-67	-29	-206	-586

Jan - June 1981

claims	-108	17	-15	115	-189	60	-13	-135
commitments	19	-2	-87	-123	-26	-49	-88	-355
total	-89	15	-102	-8	-216	11	-102	-490

POSITION

June 30, 1981

claims	315	199	1341	1001	1272	364	478	4970
commitments	33	31	71	64	109	129	361	798
total	348	230	1412	1065	1381	493	839	5768

1/ By country of guarantor, i.e., adjusted for guarantees of claims on indicated country extended by residents of other countries and for claims on other countries guaranteed by residents of indicated country.

LIMITED OFFICIAL USE

Net Position of BIS-Area Banks vs. Eastern Europe end-June 1981
\$ millions

	<u>1/</u> U.S. Banks			Non-U.S. Banks			Total		
	Claims	Liabilities	Net Claims	Claims	Liabilities	Net Claims	Claims	Liabilities	Net Claims
Albania	1	n.a.	1	1	74	-73	2	74	-72
Bulgaria	308	30	278	1,831	729	1,102	2,139	759	1,380
Czechoslovakia	197	62	135	2,976	746	2,230	3,173	808	2,365
<u>2/</u> DDR	1,038	188	850	8,590	1,628	6,962	9,628	1,816	7,812
Hungary	922	158	764	5,701	820	4,881	6,623	978	5,645
Poland	2,021	94	1,927	12,088	452	11,636	14,109	546	13,563
Romania	406	183	223	4,702	136	4,566	5,108	319	4,789
USSR	480	87	393	13,663	3,530	10,133	14,143	3,617	10,526
<u>3/</u> Residual	0	0	0	2,234	430	1,804	2,234	430	1,804
TOTAL	5,373	802	4,571	51,786	8,545	43,241	57,159	9,347	47,812

Data are for U.S. parent offices and their foreign branches and are drawn from Treasury TIC and Federal Reserve 2502 S reports.

Excludes position of banks located in the Federal Republic of Germany.

Position of banks located in Switzerland vs. all Eastern European countries.

November 25, 1981

LIMITED OFFICIAL USE

CONFIDENTIAL

U.S. Claims and Liabilities Vis-a-Vis Poland
(\$ millions)

<u>Position as of date in parentheses</u>	<u>Claims</u>	<u>Liabilities</u>	<u>Net Claims</u>
U.S. Banks' Position (9/30/81)	1,887 <u>1/</u>	144	1,743
Head Offices	(578)	(118)	(460)
Overseas Branches	(1,309)	(26)	(1,283)
Custodial Holdings by (9/30/81)			
U.S. Head Offices	13	12	1
Long-term USG Securities (9/30/81)			
and Corporate Securities	nil	nil	-
Non-banks' Financial and			
Commercial Position (3/31/81)	23	6	17
U.S. Government (6/30/81)	739	nil	739
Eximbank	(227)		
CCC	(506)		
AID	(6)		
Direct Investment (12/31/81)	<u>nil</u>	<u>nil</u>	<u>-</u>
TOTAL	2,662	162	2,500

Memorandum:

Contingent U.S.G. Liabilities
(6/30/81)

	1,083 <u>2/</u>
- Under CCC Programs	1,066
- Under EXIM Programs	17

1/ Including guaranteed claims but excluding commitments.2/ These contingent liabilities represent guarantees of private contracts with Poland and would be replaced by U.S.G. claims on Poland to the extent that Poland defaulted on these contracts. A large portion is already reflected in the claims of U.S. banks shown above.

November 30, 1981

CONFIDENTIAL